Bogus ratings of mortgage-related securities show conflicts of interest by credit rating agencies

August 16 2011, By Lloyd B. Thomas Jr

Obvious conflicts of interest and poor performance are among the reasons why a Kansas State University economist says the way the leading credit rating agencies are funded should be changed.

Standard and Poor's incompetent -- and arguably corrupt -- behavior in the years leading up to the 2007-2009 financial crisis makes its recent downgrade of U.S. debt hard for many to swallow, said Lloyd B. Thomas Jr., a K-State professor of economics and the author of a recent book about the financial crisis.

"Standard and Poor's, Fitch and Moody's -- the three leading credit rating agencies -- behaved very poorly during the housing and credit bubbles of 2000-2006," Thomas said. "Many buyers of mortgage-backed bonds can only purchase those rated AAA. The rating agencies routinely stamped mortgage-backed bonds and related derivatives AAA without carefully examining the quality of the individual mortgages that backed them."

Many of these bonds were essentially junk bonds because of the inferior quality of mortgages backing them. Thomas said this failure of the rating process helped feed an enormous expansion in the pipeline of credit to the housing sector, and its inevitable collapse after 2006 is the primary cause of the nation's economic problems today.

"These credit rating agencies have been funded by the very investment banks that built the toxic mortgage-backed bonds and related securities," he said, adding that many think that this led to corruption of the ratings process as Standard and Poor's, Moody's and Fitch engaged in a "race to the bottom."

"Standard and Poor's knew that if it failed to rate a mortgage-backed bond AAA, the investment bank would take it's business to Fitch or Moody's, which would likely rate the bond AAA in order to collect its million-dollar fee for its rating service from the investment bank," Thomas said. "Clearly this obvious conflict of interest needs to be corrected by implementing a new way of funding the rating agencies."

Thomas is the author of "The Financial Crisis and Federal Reserve Policy," which was recently published by Palgrave Macmillan.

Provided by Kansas State University

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